DEPARTMENT OF STATE REVENUE

01-20191483.LOF
04-20191484.LOF

Letter of Findings Number: 01-20191483; 04-20191484
Individual Income Tax
For Tax Years 2013-2017

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective as of its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

HOLDING

Purchases by Indiana Company were properly included in Company's business expense. However, Company could not show that the hay/feed was used in its resale portion of the business activities, and therefore use tax was properly assessed.

ISSUES

I. Individual Income Tax–Business expense deductions.

Authority: I.R.C. § 62; I.R.C. § 162; Treas. Reg. § 1.183-2; IC § 6-3-1-3.5; IC § 6-8.1-5-1; IC § 6-8.1-5-4; *Hopkins v. Comm'r*, T.C. Memo 2005-49 (2005); *Bower v. Comm'r*, T.C. Memo 1990-16 (1990); *Dept. of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *Indiana Dept. of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007).

Taxpayers protest the exclusion of deductible business expenses.

II. Use Tax–Retail sales exemption.

Authority: IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-2.5-3-1; IC § 6-2.5-3-4; *Rhoade v. Ind. Dep't of State Revenue*, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); *USAir, Inc. v. Indiana Dep't of State Revenue*, 623 N.E.2d 466 (Ind. Tax Ct. 1993); *Indiana Dept. of State Rev. v. Kimball Int'l Inc.*, 520 N.E.2d 454 (Ind. Ct. App. 1988); *Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp.,*310 N.E.2d 96 (Ind. Ct. App. 1974); 45 IAC 2.2-3-4; 45 IAC 2.2-3-14; 45 IAC 2.2-5-5.

Taxpayers protest the imposition of use tax.

STATEMENT OF FACTS

Taxpayers ("Husband and Wife") are living and working in Indiana. During the audit period, Taxpayers operated a horse breeding and training facility. The Indiana Department of Revenue ("Department") conducted an income tax audit and sales/use tax audit of Taxpayers for the tax years 2013 through 2017. The Department's income tax audit found that expenses resulting from the purchase of horse breeding, training, and boarding had been improperly deducted as business expenses, and that Taxpayers had overstated their deduction for fuel expenses. The Department's sales/use tax audit found that Taxpayers made several purchases of items subject to sales and use tax. As a result, the Department assessed additional income tax and gross retail tax against Taxpayers. Taxpayers only protest the income and use tax portion of the audit, and do not protest the sales tax portion.

A hearing was held during which Taxpayers and Taxpayers' representative explained the basis of their protest. This Letter of Findings results. Additional facts will be provided as necessary.

I. Individual Income Tax–Business expense deductions.

DISCUSSION

Taxpayers protest the disallowance of certain business expense deductions originally reported on the corporate income tax returns for the tax years 2013-2017. The Department determined that the purchases for the horses were not eligible as business deductions because the purchases were made as the individual shareholder's hobby. The Department also assessed use tax on the purchase of hay because the hay is being used by Taxpayers for feed and bedding, and could not provide information which hay was used for feed and bedding or resale.

Taxpayers argue that the horse breeding, boarding, and showing is their business. Taxpayers provided an IRS audit showing that the IRS did not deny the business deductions. Taxpayers also provided several invoices, contracts, ledger accounts, business plans, etc. to show that they treat this as a business. Taxpayers state that they have maintained all documentation for items of income and expense; accounted for all transactions; retained and produced detailed documentation; and kept significant records.

As a threshold issue, it is a taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." *Indiana Dept. of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Consequently, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. Further, "[w]hen [courts] examine a statute that an agency is 'charged with enforcing. . .[courts] defer to the agency's reasonable interpretation of [the] statute even over an equally reasonable interpretation by another party.'" *Dept. of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579, 583 (Ind. 2014). Thus, all interpretations of Indiana tax law contained within this decision, as well as the preceding audit, shall be entitled to deference.

Indiana defines the term adjusted gross income "as [it is] defined in Section 62 of the Internal Revenue Code" with Indiana-specific modifications. IC § 6-3-1-3.5(a). Section 62 of the Internal Revenue Code defines adjusted gross income as "gross income minus [specific] deductions" which includes "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." I.R.C. § 62(a); I.R.C. § 162. Certain deductions are allowed for businesses for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ." I.R.C. § 162. "Ordinary" refers to expenses that "should have a reasonably proximate relation to the operation of [a taxpayer's] trade or business." *Bower v. Comm.*, T.C. Memo 1990-16 (1990). A general statement that "expenses were incurred in pursuit of a trade or business is not sufficient to establish that the expenses had a reasonably direct relationship to any such trade or business." *Hopkins v. Comm'r*, T.C. Memo 2005-49 (2005).

Activities conducted as hobbies are not deductible as ordinary and necessary expenses under I.R.C. § 162. In order to determine whether a taxpayer's activity constitutes a business or a hobby, the IRS employs a nine-factor test set forth in Treas. Reg. § 1.183-2(b). The nine factors are as follows:

> **Relevant factors**. In determining whether an activity is engaged in for profit, all facts and circumstances with respect to the activity are to be taken into account. No one factor is determinative in making this determination. In addition, it is not intended that only the factors described in this paragraph are to be taken into account in making the determination, or that a determination is to be made on the basis that the number of factors (whether or not listed in this paragraph) indicating a lack of profit objective exceeds the number of factors indicating a profit objective, or vice versa. Among the factors which should normally be taken into account are the following:
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> > **(1) Manner in which the taxpayer carries on the activity**. The fact that the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate books and records may indicate that the activity is engaged in for profit. Similarly, where an activity is carried on in a manner substantially similar to other activities of the same nature which are profitable, a profit motive may be indicated. A change of operating methods, adoption of new techniques or abandonment of unprofitable methods in a manner consistent with an intent to improve profitability may also indicate a profit motive.
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> > **(2) The expertise of the taxpayer or his advisors.** Preparation for the activity by extensive study of its accepted business, economic, and scientific practices, or consultation with those who are expert therein, may indicate that the taxpayer has a profit motive where the taxpayer carries on the activity in accordance with such practices. Where a taxpayer has such preparation or procures such expert advice, but does not carry on the activity in accordance with such practices, a lack of intent to derive profit may be indicated unless it appears that the taxpayer is attempting to develop new or superior techniques which may result in profits from the activity.

(3) The time and effort expended by the taxpayer in carrying on the activity. The fact that the taxpayer devotes much of his personal time and effort to carrying on an activity, particularly if the activity does not have substantial personal or recreational aspects, may indicate an intention to derive a profit. A taxpayer's withdrawal from another occupation to devote most of his energies to the activity may also be evidence that the activity is engaged in for profit. The fact that the taxpayer devotes a limited amount of time to an activity does not necessarily indicate a lack of profit motive where the taxpayer employs competent and qualified persons to carry on such activity.

(4) Expectation that assets used in activity may appreciate in value. The term profit encompasses appreciation in the value of assets, such as land, used in the activity. Thus, the taxpayer may intend to derive a profit from the operation of the activity, and may also intend that, even if no profit from current operations is derived, an overall profit will result when appreciation in the value of land used in the activity is realized since income from the activity together with the appreciation of land will exceed expenses of operation. See, however, paragraph (d) of § 1.183-1 for definition of an activity in this connection.

(5) The success of the taxpayer in carrying on other similar or dissimilar activities. The fact that the taxpayer has engaged in similar activities in the past and converted them from unprofitable to profitable enterprises may indicate that he is engaged in the present activity for profit, even though the activity is presently unprofitable.

(6) The taxpayer's history of income or losses with respect to the activity. A series of losses during the initial or start-up stage of an activity may not necessarily be an indication that the activity is not engaged in for profit. *However, where losses continue to be sustained beyond the period which customarily is necessary to bring the operation to profitable status such continued losses, if not explainable, as due to customary business risks or reverses, may be indicative that the activity is not being engaged in for profit.* If losses are sustained because of unforeseen or fortuitous circumstances which are beyond the control of the taxpayer, such as drought, disease, fire, theft, weather damages, other involuntary conversions, or depressed market conditions, such losses would not be an indication that the activity is not engaged in for profit. A series of years in which net income was realized would of course be strong evidence that the activity is engaged in for profit.

(7) The amount of occasional profits, if any, which are earned. The amount of profits in relation to the amount of losses incurred, and in relation to the amount of the taxpayer's investment and the value of the assets used in the activity, may provide useful criteria in determining the taxpayer's intent. *An occasional small profit from an activity generating large losses, or from an activity in which the taxpayer has made a large investment, would not generally be determinative that the activity is engaged in for profit.* However, substantial profit, though only occasional, would generally be indicative that an activity is engaged in for profit, where the investment or losses are comparatively small. Moreover, an opportunity to earn a substantial ultimate profit in a highly speculative venture is ordinarily sufficient to indicate that the activity is engaged in for profit even though losses or only occasional small profits are actually generated.

(8) The financial status of the taxpayer. The fact that the taxpayer does not have substantial income or capital from sources other than the activity may indicate that an activity is engaged in for profit. *Substantial income from sources other than the activity (particularly if the losses from the activity generate substantial tax benefits) may indicate that the activity is not engaged in for profit especially if there are personal or recreational elements involved.*

(9) Elements of personal pleasure or recreation. The presence of personal motives in carrying on of an activity may indicate that the activity is not engaged in for profit, especially where there are recreational or personal elements involved. On the other hand, a profit motivation may be indicated where an activity lacks any appeal other than profit. It is not, however, necessary that an activity be engaged in with the exclusive intention of deriving a profit or with the intention of maximizing profits. For example, the availability of other investments which would yield a higher return, or which would be more likely to be profitable, is not evidence that an activity is not engaged in for profit. An activity will not be treated as not engaged in for profit merely because the taxpayer has purposes or motivations other than solely to make a profit. Also, the fact that the taxpayer derives personal pleasure from engaging in the activity is not sufficient to cause the activity to be classified as not engaged in for profit if the activity is in fact engaged in for profit as evidenced by other factors whether or not listed in this paragraph.

(*Emphasis added*).

The Department evaluated Taxpayers' activity under each factor. The Department determined that Taxpayers did not keep sales invoices for revenue received by operation; in addition, Taxpayers had expense payments made from a combined personal and business bank account. Taxpayers do have separate accounts. Furthermore, Taxpayers provided a business plan and list of changes made and special talent hired since 2008, but none of these efforts resulted in a net income across all the audited years. The Department stated that, "although the [T]axpayers did maintain some records of income and expense transactions, the [T]axpayers did not follow standard business practices as the [T]axpayers did not issue invoices to customers and did not separately track all income sources and expense types commingling their bank account transactions and expense deductions for the horse activity items and their personal items."

In regards to factor two, expertise, the Department determined that Taxpayers are knowledgeable in this field. The Department stated in the audit report, that "overall this factor is neutral. The [T]axpayers have some knowledge in their respective fields and have sought the help of hired experts; however, the expertise developed or hired did not result in extensive study or documented procedures to be followed by [T]axpayers." For Factor three, time and effort, the Department determined that "both [T]axpayers have other material full-time employment as reflected by their W-2 income. . . . Overall, this factor is neutral. Horses do require a bit of care. However, the [T]axpayers have full-time employment outside of these activities, which also require significant travel away from home."

Next the Department discussed factor four, appreciating asset expectation. Taxpayers' main asset is their land, which is their home. In addition, Taxpayers have award winning horses that they also show. The audit report stated that Taxpayers did not show any interest in selling their assets to recoup losses. Thus the Department determined that Taxpayers are not interested in making a profit and weighed factor four against Taxpayers. Factor five, success in similar or dissimilar activities, was weighed against Taxpayers in the audit because, "The [T]axpayers were asked if they had any other enterprise where they converted the business from unprofitable to profitable, and they replied that they did not."

The Department also weighed factors six, seven, and eight against Taxpayers. All three factors deal with profits and losses and financial status with respect to the activity. The Department determined in the audit report that Taxpayers have a long history of losses. According to the audit report, no profits were reported in any year audited. "In summary, the [T]axpayers could not show that they generated any net profits from their activities of the past twenty years and have reported losses for the activities for over twenty years." The audit report stated that both Taxpayers have other income per W-2. Taxpayers have started this activity in 1998, but has owned horses for forty years. The audit report stated that "in all years since 1998, the [T]axpayers have been earning losses. . . . Losses from the activity would thus be off-setting the [T]axpayers' substantial income from other sources for over [twenty] years."

The final factor, elements of personal pleasure or recreation, was also weighed against Taxpayers. The Department determined that Taxpayers have been involved in the horse industry for over 40 years and that "constant care of animals may not be seen as a complete recreational activity as it does require lots of effort, the [T]axpayers' extended involvement and decades of substantial losses would point to their being other motives for this activity other than profit." Based on all these reasons, the Department determined that the losses were not part of a business activity and rather a hobby.

Taxpayers protest the Department's determination for each factor. Taxpayers explained that they keep very detailed records and in fact the sales and use tax assessments were based on their documentation. Taxpayers stated that all revenue, cash or check, was and is deposited into the checking account or processed through PayPal. In addition there were no extravagant travel expenditures or personal expenditures. Taxpayers go on to state that they are very knowledgeable in the horse industry, and the Wife is a Certified Public Accountant capable of record keeping for the business. Thus, Taxpayers claim that their knowledge and background enables them to run a business. In regards to Factor three, time and effort, Taxpayers state that in 2013 and 2014 Husband dedicated his full time employment to the business, and when he did work outside of the business his work related to the horse industry. Furthermore, Husband was hired to manage a trailer dealership in 2015 to sell and manage horse related cliental of the dealership. Taxpayers go onto to explain that both Husband and Wife are available at all hours to tend to the business' clients and horses. Wife manages most of the breeding inquiries. Taxpayers estimate that from 2015 to present, they spent an average of at least 30 hours per week conducting the business. To support this Taxpayers broke down the business' revenue in relation to W2 income:

- 2013 Business revenue is 410[percent] of W2 income ([Husband] did not work outside the business).
- 2014 Business revenue is 320[percent] of W2 income ([Husband] did not work outside the business).
- 2015 Business Revenue is 154[percent] of W2 income.

- 2016 Business Revenue is 100[percent] of W2 income.
- 2017 Business Revenue is 72[percent] of W2 income.

In regards to Factor four, expectation of appreciating assets, Taxpayers state that the audit report was incorrect in noting that Taxpayers did not intend to sell assets, stallions or property of the business. Taxpayers stated that they try to generate more revenue and this has and does involve the sale of horses when appropriate. Next Taxpayers explained that in 2016 and 2018 they were approached by two separate real estate brokers with two separate parties interested in purchasing their assets. However no sale resulted. Taxpayers stated that they will also consider selling assets in the future. Taxpayers go onto to state that they have extensive knowledge and while selling horse trailers Husband grew that business from $1.8 million to $3 million in revenue in about three years. Taxpayers also state that while the business has not operated at a profit it has been managed and directed as a proper business; Taxpayers are confident that based on the past three-four years they have corrected the process and operations to make the business profitable. Taxpayers even provided a recent break-even analysis which shows that it is very possible that Taxpayers have taken a turn and will be profitable in the future.

Taxpayers also explained that they have experienced several extraordinary cost and expenditures which have not and cannot be planned for as they are in unexpected; for instance, half of their foals died unexpectedly within a week of birth. This resulted in a loss of potential revenue of $10,000 or more. Taxpayers explained that pleasure or enjoyment that comes from running their business does negate the fact that they run it as a business. Taxpayers have evolved and adapted their business plans to reflect whatever situation necessary. They have had and continue to have business plans to try and create a profit for their business.

Taxpayers also claimed to have been audited by the IRS for 2009 with regards to their business. Taxpayers claim that the IRS determined that they were a business not a hobby. When the Department initially reviewed the report, the Department determined that the IRS did not classify Taxpayers' operations as a hobby. During the protest process, the Department reexamined the IRS audit report and has now determined that while the IRS did not explicitly say "Taxpayer is conducting a business" it allowed the expenses as a business expenses and did say that Taxpayers had made changes that would result in an opportunity for them to be profitable.

While the previous IRS audit report is reliable evidence, it does not apply to the years at issue. Thus it can only be used as evidence of Taxpayers' business activities in 2009, and is not a determinative factor. Taxpayers provided information to show that they are in fact conducting a business, and not a hobby. Taxpayers provided detailed ledgers, samples of billings to customers, performance fee schedules, boarding revenue statements, breeding contracts, proof of sales for horses, and stud fees. They also provided income statements from 2013-2017. Taxpayers' business consists of caring for live and expensive animals that can result in a large amount of expenses. In addition, Taxpayers have made plans to try and reduce expenses and generate more income. Taxpayers have demonstrated that the manner in which they carry out the disputed activities are in fact engaging in business activity. They rely on their own expertise and have hired other experts to grow their business. Though at times both Taxpayers have held additional employment, their continuous activities and time spent managing the horses' support that Taxpayers were running a business. Having outside employment does not change the nature of the activities at issue. Taxpayers kept contemporaneous records regarding the nature of the business and they are sufficient to prove the proposed assessments wrong, as required by IC § 6-8.1-5-1(c).

FINDING

Taxpayers' protest with respect to disallowed business expenses deductions is sustained.

II. Use Tax–Retail sales exemption.

DISCUSSION

The sales and use tax audit report assessed Taxpayers additional sales and use tax on certain transactions. Taxpayers only protest the use tax portion of the assessment. The audit report stated that Taxpayers purchased hay without paying sales tax, thus use tax must be assessed. The audit report stated that "The Taxpayer did not provide detail showing how much hay is being used as part of its resale operation." Thus the Department assessed use tax on the hay.

Indiana imposes an excise tax called "the state gross retail tax" (or "sales tax") on retail transactions made in Indiana. IC § 6-2.5-2-1(a). A person who acquires property in a retail transaction (a "retail purchaser") is liable for the sales tax on the transaction. IC § 6-2.5-2-1(b). Indiana also imposes a complementary excise tax called "the use tax" on "the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction." IC § 6-2.5-3-2(a). Use means the "exercise of any right or power of ownership over tangible personal property." IC § 6-2.5-3-1(a).

The use tax is functionally equivalent to the sales tax. *See Rhoade v. Ind. Dep't of State Revenue*, 774 N.E.2d 1044, 1047 (Ind. T.C. 2002). By complementing the sales tax, the use tax ensures that non-exempt retail transactions (particularly out-of-state retail transactions) that escape sales tax liability are nevertheless taxed. *Id*. at 1048; *USAir, Inc. v. Indiana Dep't of State Revenue*, 623 N.E.2d 466, 469 (Ind. Tax Ct. 1993). An exemption from the use tax is granted for transactions where the sales tax was paid at the time of purchase pursuant to IC § 6-2.5-3-4 and 45 IAC 2.2-3-4. There are various tax exemptions available under IC 6-2.5-5; these enumerated exemptions also apply to transactions which are subject to Indiana use tax. 45 IAC 2.2-3-14.

Taxpayer has the burden of establishing that it is entitled to the sought after exemption. In applying any tax exemption, the general rule is that "tax exemptions are strictly construed in favor of taxation and against the exemption." *Indiana Dept. of State Rev. v. Kimball Int'l Inc.*, 520 N.E.2d 454, 456 (Ind. Ct. App. 1988). A statute which provides a tax exemption, however is strictly construed against the taxpayer. *Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp.,*310 N.E.2d 96, 97 (Ind. Ct. App. 1974). "[W]here such an exemption is claimed, the party claiming the same must show a case, by sufficient evidence, which is clearly within the exact letter of the law." *Id.*at 101 (citing *Conklin v. Town of Cambridge City,*58 Ind. 130, 133 (1877)).

45 IAC 2.2-5-5 states:

> (a) The raising of saddle horses, harness horses, ponies, donkeys, or any other similar animals not used directly in direct agricultural production does not qualify as agricultural production for "human consumption" under the gross retail sales and use tax act. Consequently, the purchase of supplies, food, materials, and equipment used in raising or maintaining such animals are subject to the sales tax unless the items are directly used or consumed in the production of such animals for resale in the regular course of the purchaser's business.

Taxpayers did not provide documentation to show which hay was at issue and how that hay is used in its resale operations. Taxpayers only stated that they believe the use tax is not applicable to the hay because it is used in the business operations. However, the regulation does not grant the exemption based solely on business activity. The feed/hay must be used directly for the animals that are for resale. Taxpayers run several aspects of the business that would use hay but as a part of their resale side of the business. The Department concludes that Taxpayers did not meet the requirements for the resale exemption to apply to the hay/feed purchases, and therefore has not met its burden under IC § 6-8.1-5-1(c) of showing that the proposed assessment of additional use tax was incorrect.

FINDING

Taxpayers' protest of use tax assessed is denied.

SUMMARY

Taxpayers' protest with respect to Issue I is sustained, but Issue II is respectfully denied.

May 19, 2020

Posted: 07/29/2020 by Legislative Services Agency
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